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Holding Innovation to an Antitrust Standard

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A Simple Model

- Old technology has social value v_0 for each use
- New technology has social value $v_1 > v_0$
- Zero marginal costs
- N users
- R&D cost R



A Simple Model

- Innovation is socially desirable if
$$N(v_1 - v_0) > R$$
- If P_1 is the price the innovator can collect for the new technology, it is privately profitable if $NP_1 > R$
- Innovations can be socially desirable but not privately profitable, or privately profitable but not socially desirable



Antitrust Standards

- Total Rule of Reason
- Consumer Rule of Reason
- Profit Sacrifice
- No Economic Sense
- Sham Innovation



Total Rule of Reason

- Should account for spillover costs and benefits
 - Can have $P_1 > v_1 - v_0$ or $P_1 < v_1 - v_0$
- Should account for ex ante innovation incentives
- Sheer complexity can lead to false positives and false negatives



Consumer Rule of Reason

- Similar problems as with a total rule of reason analysis (spillovers, complexity, ex post v. ex ante, etc)
- Can lead to conclusions that don't make sense
 - E.g., A process innovation that saves many millions, but increases prices by a few cents



Profit Sacrifice Test

“Predatory intentions are present if a practice would be unprofitable without the exit that it causes, but profitable with the exit.”

Ordover and Willig, “An economic definition of predation: pricing and product innovation,” *Yale L.J.*, 91(1) (1981)



Profit Sacrifice Test

- Innovation almost always involves a profit sacrifice
- Innovation sometimes excludes competitors
- Exclusion of competitors may be necessary to motivate efficient investment in research and development
- Profit sacrifice is not a useful test for predatory innovation



No Economic Sense Test

“Conduct is not exclusionary or predatory unless it would make no economic sense for the defendant but for the tendency to eliminate or lessen competition.”

Werden, “Identifying exclusionary conduct under Section 2: The “No Economic Sense” Test,” *Antitrust L. J.*, 73(2) (2006)



No Economic Sense Test

Two interpretations of “no economic sense”
applied to innovation –

- (1) Innovation is not profitable
- (2) Innovation always makes economic sense



No Economic Sense Test

If (1), the no economic sense test is similar to the profit sacrifice test

If (2), the no economic sense test is similar to a sham innovation test



Predatory Innovation for Complements

- IBM peripherals litigation (late 1970s)
- Microsoft
- Others (e.g. Bard v. M3 Systems)



Predatory Innovation for Complements

- In nearly all cases, weak evidence of efficiencies was sufficient to avoid liability for predatory innovation
- Only Microsoft purported to apply a rule of reason analysis



U.S. v. Microsoft

- The plaintiff must demonstrate that the conduct harmed consumers (an anticompetitive effect);
- if a plaintiff successfully demonstrates anticompetitive effect, then the monopolist may proffer a procompetitive justification for its conduct; and
- the plaintiff can rebut the proffered procompetitive justification or, if the justification stands unrebutted, then the plaintiff must demonstrate that the anticompetitive harm of the conduct outweighs the procompetitive benefit.



U.S. v. Microsoft

- Three challenged design elements
 - i) excluding IE from the “Add/Remove Programs” utility;
 - ii) designing Windows so as in certain circumstances to override the user's choice of a default browser other than IE; and
 - iii) commingling code related to browsing and other code in the same files, so that any attempt to delete the files containing IE would, at the same time, cripple the operating system.
- Court concluded that Microsoft offered no procompetitive justifications for (i) and (iii)
- Court concluded that plaintiffs did not rebut Microsoft’s justifications for (ii)



U.S. v. Microsoft

Court never got to the rule of reason balancing in the third step

The practical effect of the Court's analysis was similar to a "no economic sense" test



Product line extensions in the pharmaceuticals industry

Drug patents that may delay generic competition:

Tricor: used to control blood triglyceride and lipid (cholesterol) levels

Prilosec/Nexium: for treatment of persistent heartburn (Prilosec and Nexium) and esophageal and duodenal ulcers (Nexium)



Product line extensions in the pharmaceuticals industry

Allegations that:

- Innovations are costly, but minor, improvements
- Contrary to the intent of Hatch-Waxman legislation
- Have adverse competitive effects by delaying generic competition



Product line extensions in the pharmaceuticals industry

Issues:

- Hatch-Waxman legislation was a tradeoff between more generic competition and more protection for patented drugs
- Product line extensions increase incentives for drug innovation
- Hard to assess innovation benefits



Consistency with Other Antitrust Rules

“Too many people make decisions based on outcomes, rather than process.”

Michael Lewis, quoting Paul DePodesta in *Moneyball*
(2004)



Consistency with Other Antitrust Rules

- Most innovations that exclude competitors have effects that are no more severe than a refusal to deal. E.g.,
 - IBM refuses to make mainframes compatible with third party components
 - Microsoft refuses to make Windows compatible with other browsers
 - Branded drug manufacturer refuses to supply a drug that generics can copy



Consistency with Other Antitrust Rules

- Yet a unilateral refusal to deal rarely incurs antitrust liability
 - Verizon v. Trinko



Conclusions

- Rule of reason and profit sacrifice tests have limited value to evaluate predatory innovation
 - Hard to do, likely to get wrong answer
- No economic sense is better, but only if interpreted as a test of sham innovation
- This is what courts typically have done, and is probably at least as good an approach as any